

AAOIFI rulings on Sukuk and its implications

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AAOIFI's Statement on Sukuk – the Issues

- ❑ There are three fundamental issues in the AAOIFI Statement
 - ❑ Ownership in underlying assets
 - ❑ Purchase Undertaking in *Mudaraba, Wakala, and Musharakah*
 - ❑ Profit distribution mechanism

Ownership in Shariah

- ❑ Allah is the owner of everything as the Quran says **“To Allah does belong the dominion of the heaven and the earth, and all that is therein”** Al Ma’eedah Verse 120.
- ❑ Relation between men and men distinct from relation between Allah and men.
- ❑ Ineligible for ownership, specified for public usage such as public roads, rivers, museums, parks, etc.

Ownership in Shariah

□ Eligibility for Ownership:

A. Milkiyyah Naqisah (incomplete ownership) ownership of property alone whereas the usufruct owned by some one else and can come in many forms

- Simple loan (without compensation)
- Lease
- Permission

B. Milkiyyah Kamilah (Complete Ownership)

Ownership in Shariah

Ownership of Underlying Assets:

- AAOIFI guidelines (also Int. Islamic Fiqh Academy's Resolutions) require:

“All [tradable] Sukuk must represent ownership in the underlying real assets (real, usufruct, services) with all rights and obligations) which can be owned and sold in accordance with Sharia and applicable law. Transfer of ownership must be recorded in the seller's books as per Sharia and applicable legal requirements and should not be shown as the assets of seller or manager)”

Ownership in Shariah

- ❑ It is an established principle of Islamic jurisprudence that “ownership” is required in a contract of sale. The Prophet PBUH said, **“Do not sell what you do not own”**.
- ❑ Ownership (partial or full) in the underlying asset is required for all types of Shariah compliant structures
- ❑ Ownership distinguished from possession/delivery
- ❑ Sukuk assets sold to Sukukholders must not appear on the balance sheet of the seller.
- ❑ A debt cannot be traded except at par value

AAOIFI and Purchase Undertaking

- ❑ What is the issue?
- ❑ An undertaking to purchase Sukuk assets at face value considered a guarantee for the capital thus eliminating the possibility of profit and loss – an essential element of Islamic investment products.
- ❑ The ruling applies to Musharakah, Mudaraba and Investment agency Sukuk (Trust based)
- ❑ Excludes Ijarah (Debt based)

- ❑ Does the PU amount to guaranteeing the capital OR is it a document enabling the Sukuk holders to dispose of the underlying assets on maturity.

AAOIFI and Purchase Undertaking

- ❑ Purchase undertaking does not constitute a guarantee as the promissor is not under obligation to purchase the underlying assets in all circumstances whereas the guarantee is an agreement to indemnify in all cases.
- ❑ Not exercisable in case of total loss, partial loss, expropriation, compulsory acquisition; a guarantee is enforceable in all cases.
- ❑ The promisor may not sign the sale and purchase agreement even if the Promisee has exercised the PU leaving the Promisee to sue for damages.

Profit Distribution in Sukuk – the issues

- ❑ The use of bench mark

- ❑ “If the profit payable to the Rab Al Mal or partner or manager is more than an agreed benchmark the surplus shall be paid to Mudarib or partner or manager as incentive.”

- ❑ In principle, all profit should be for the Sukukholders but the documents obligate the manager to pay an agreed percentage or agreed benchmark based return to Sukukholders.

Profit Distribution in Sukuk – the mechanism

Sharia Position:

- ❑ Profit must be from the underlying assets or the activities related to Mudaraba, Musharakah or Wakala.
- ❑ In Mudaraba for a specific project, profit is distributed between the Rab Al Mal and Mudarib on an agreed percentage

- ❑ Mudaraba on co-mingling basis, a two-tier profit distribution.
- ❑ Incentive to Mudarib is paid from the Rab Al Mal's share of profit if the profit exceeds a certain threshold.
- ❑ Losses are borne by the Rab Al Mal in the absence of negligence, misconduct or breach

Q&A

Thank You!

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